A YEN FOR PROFIT:

RICHARD W. WRIGHT
with SUSAN HUGGETT

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A Yen For Profit:
Canadian Financial Institutions in Japan

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by

Richard W. Wright

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Foreword

Japan has become the world's largest capital exporter, and Tokyo has emerged suddenly as one of the key financial centers of the world, threatening – or promising – to eclipse even London and New York in importance. A recent issue of the Service Barometer published by the European Service Industries Forum notes, for example, that four of the five largest banks in the world are Japanese (with Dai Ichi Kangyo being the largest in the world), and anticipates that before 1990 all five will be Japanese. Similarly, four of the five largest security houses in the world are Japanese (with Nomura Securities the largest of all).

Of course, no one who looks back at the post-war record of shifting imbalances in world trade patterns and international financial flows will be willing to forecast inevitable continuation of current trends in international payment balances. Moreover, implementation of the 1986 Maekawa report recommending massive restructuring of the Japanese economy has yet to take hold, and the possible consequences of proposed major tax reforms in Japan, including removal of preferential treatment of the postal savings deposits which play such an important role in Japanese savings behavior, are difficult to anticipate. Nevertheless, accommodation to the role of Japan as a structural capital exporter in the world economy does seem likely to be one

enduring fact of life for Western economies over the foreseeable future.

The implications for Canada of growth and change in Japanese financial markets thus are clearly important, if not always clear. In this monograph, Richard Wright, author of an earlier Institute publication, *Japanese Business in Canada: The Elusive Alliance*, and co-author with Gunter Pauli of a forthcoming book, *The Second Wave: The Global Challenge of Japanese Financial Services*, sketches some of these recent developments in Japanese financial markets, and speculates on their significance for Canada, Canadian financial institutions, the financial relationship between Canada and Japan, and Canada's role in the international marketplace for financial services.

Wright presents first an overview of the nature, magnitude and impact of Japanese financial flows to Canada. He then analyses the competitive position of Canada's banks and securities companies in Japan, describing the nature of their activities and their major strategic thrusts. He points out where their main vulnerabilities might lie, and suggests some of the new competitive niches which offer growth opportunities for the future. A final section focusses on the sweeping changes currently underway in the regulatory environments of both Canada and Japan, drawing some conclusions about their likely impact on the competitiveness of Canada's financial service firms.

Because of the current relevance of this work, the Institute has undertaken to publish this document as a polished working paper designed to reach a wide audience in a timely manner, rather than as a definitive account of finished academic research. As such, it forms part of our larger ongoing program of research on internationally traded services, initiated with the financial support of the Government of Canada, Department of Regional Industrial Expansion. It is our hope that this paper will be of interest to those participating in, or studying, the activities of this fascinating industry in ferment, the international world of banking and financial services.

A.R. Dobell
President

February 1987

Avant-propos

Le Japon est aujourd'hui le plus gros exportateur de capitaux du monde, et Tokyo se trouve être devenu un centre-clé de la finance mondiale, menaçant même, ou promettant de dépasser Londres et New York. Dans un numéro récent du "Service Barometer", publié par le Forum des industries de services d'Europe, on peut lire entre autres que quatre des cinq plus grandes banques du monde se trouvent au Japon (la Dai Ichi Kangyo étant la première), et que l'on s'attend à ce que toutes les cinq soient japonaises d'ici 1990. Il en va de même pour les cinq plus grandes maisons de courtage du monde : quatre d'entre elles sont japonaises (Nomura étant la plus importante de toutes).

Personne bien sûr ne peut affirmer que la situation économique internationale actuelle continuera inévitablement dans cette voie, il suffit de se remémorer le désordre de l'après-guerre en matière d'changes internationaux et de circulation de capitaux. En outre, la mise en application du rapport Maekawa de 1986, qui préconise une restructuration complète de l'économie japonaise, n'a pas encore produit tous ses effets. Il est difficile de prévoir les conséquences des importantes réformes fiscales que le Japon se propose de réaliser, entre autres celles visant à la suppression du traitement préférentiel jusqu'ici réservé aux très populaires dépôts d'épargne des postes. Pourtant, les économies occidentales devront se faire à l'idée que

le Japon est devenu l'un des plus grands exportateurs de capitaux du monde, et qu'il le restera probablement dans le futur prévisible.

Les effets des changements et de la croissance des marchés financiers japonais sur l'économie canadienne sont évidemment importants, même si les implications ne sont pas toujours évidentes. Dans cette monographie, Richard Wright, auteur d'un ouvrage déjà publié par l'Institut, *Japanese Business in Canada: The Elusive Alliance* (L'Alliance insaisissable), sur les investissements japonais au Canada, et co-auteur avec Gunter Pauli d'une prochaine publication, *The Second Wave: The Global Challenge of Japanese Financial Services* (La seconde vague: le défi global des services financiers japonais), relève certaines transformations récentes dans les marchés financiers japonais et fait des conjectures sur leurs conséquences pour notre pays, pour nos institutions financières, pour nos relations financières avec le Japon, et pour le rôle du Canada dans le marché international des services financiers.

Wright présente tout d'abord une vue d'ensemble de la nature, de l'importance et de l'impact de l'entrée des capitaux japonais au Canada. Il analyse ensuite la position concurrentielle qu'occupent les banques et les compagnies financières canadiennes au Japon, en faisant la description de la nature de leurs activités et de leurs stratégies les plus importantes. Il indique où peuvent se situer leurs faiblesses et suggère quelques nouveaux créneaux qui offrent de bonnes possibilités d'avenir. Enfin, dans la dernière partie de l'ouvrage, il examine les changements en cours dans la réglementation au Japon et au Canada et tire des conclusions quant à l'impact que ces changements risquent d'avoir sur l'esprit concurrentiel des firmes financières canadiennes.

C'est le caractère d'actualité de cette étude, susceptible d'intéresser un large public, qui a décidé l'Institut à la publier, sans attendre qu'elle atteigne le stade d'un rapport académique définitif. Cet ouvrage, tel qu'il est, cadre bien avec le programme de recherche sur les services internationaux entrepris par l'Institut avec l'aide financière du gouvernement du Canada, du ministère de l'Expansion industrielle régionale. Nous espérons qu'il saura plaire à tous ceux qui s'intéressent aux activités de cette fascinante industrie en pleine évolution du monde international des services banquiers et financiers.

A.R. Dobell
Président
Février 1987

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Summary

One of the most important developments in the current world economy is the sudden emergence of Tokyo as a major international financial center. Canada's chartered banks and securities companies are relative newcomers to Japan, and they are struggling to position themselves effectively in that dynamic, challenging market.

Fuelled by an extraordinarily high domestic savings rate, capital outflow from Japan has grown at an astonishing pace, with over $82 billion (US) of long-term capital flowing abroad in 1985. Just as Japan achieved world pre-eminence in many manufacturing sectors during the 1960s and 1970s, it is now poised to become a dominant player in the global financial scene.

The Japanese are low risk-takers in their overseas investments. Most of their capital outflow goes to stable economies such as the United States, Canada and Australia. The preponderance is in the form of liquid portfolio investments, although there is substantial growth also in Japanese direct investments overseas.

The impact of Japanese capital flows on Canada is profound. On a per-capita basis, Canada is the largest external recipient of Japanese capital. Japan currently holds well over $10 billion of Canadian federal and provincial government bonds, a substantial portion of the national debt. Indications are that this inflow will

continue at very high levels. The main Japanese investors in Canadian securities are institutions such as life insurance companies and the trust banks which administer Japanese pension funds.

While massive inflows of Japanese capital benefit Canada's economy in many ways, they also pose some major problems. One is the enormous concentration of external financing in the institutions of a single country. Another is the high liquidity of the Japanese portfolio investments, making Canada vulnerable to sudden withdrawals.

Canada's major chartered banks had representative offices in Tokyo for a number of years, but their branch status dates back only to 1981. For the most part, their performance to date has been disappointing. Spread-based lending activities in Japan have been especially difficult. On the funding side, Japanese banks have access to massive amounts of low-cost deposit funds which enables them to price their commercial loans well below those of most foreign banks. On the lending side, Canadian and other foreign banks are handicapped by the strong traditional ties between commercial borrowers and Japanese banks of the same industrial groups. Trade finance provides a modest but stable flow of earnings.

Far more promising for Canadian banks are new money and capital market activities made possible by progressive deregulation of the Tokyo financial market. A prime objective of most of the Canadian banks in Japan is to tap into that low-cost source of capital to fund their activities elsewhere. A wide range of new opportunities exists also for currency and interest-rate arbitrage and speculation through a variety of innovative swap arrangements. Efforts by Canadian banks to redirect their emphasis in Tokyo away from traditional commercial banking activities toward greater capital-market involvement are handicapped both by Japanese Ministry of Finance regulations precluding financial institutions from engaging in both commercial and investment banking, and by their own relative inexperience in merchant-banking activities.

Canadian securities companies have done well in Japan in recent years, thanks mainly to the seemingly unquenchable Japanese appetite for investing in foreign securities. Most of their activity is focussed on the sale of Canadian government bonds to Japanese institutional investors. The Japanese have shown relatively little interest in Canadian equities, and until very recently Canadian investment in Japan has not been significant. Although Canadian houses presently dominate the Canadian bond market in Japan, their pre-eminence is

threatened by increasingly aggressive competition from Japanese and other foreign dealers both in Canada and in Japan. As a consequence, the Canadian companies are moving aggressively to broaden their activities in the Tokyo market, particularly toward equity sales, private placements, and swap arrangements. In a competitive environment demanding enormous investments in sophisticated electronic equipment and a broad inventory of securities holdings, however, the Canadian companies are handicapped by capital bases only a fraction as large as those of their major competitors.

All of the Canadian securities companies presently operating in Japan do so through representative offices rather than branches. Although this poses some competitive disadvantages, the small size of the Canadian houses and their relatively minor emphasis on equities makes any change in status unlikely for the forseeable future.

Both Canada's banks and securities companies face increasingly intense competition in Tokyo. Their problems are exacerbated by the extremely high cost of office space in Tokyo, and by their great difficulty in attracting highly-qualified Japanese staff.

While the position of Canadian financial institutions in Japan is affected immediately by current deregulation of the Tokyo financial market, it will also be reshaped significantly by imminent regulatory changes in Canada as well. New rules introduced by the Ontario Securities Commission, and accompanying amendments expected to the federal Bank Act, will permit both Canadian chartered banks and foreign financial institutions to acquire ownership and control of Canadian securities companies. The new rules, when fully implemented, will undoubtedly pose new challenges to the Canadian securities industry at home. But they will also provide significant new opportunities for both the banks and the securities companies to compete in major overseas markets such as Tokyo. First, the new rules will facilitate the linkage of small Canadian dealers with major foreign firms with larger capital bases and global expertise. Moreover, they will permit the large Canadian chartered banks to acquire ownership in Canadian securities companies, equipping both types of institutions to compete more effectively abroad. The securities companies will benefit from the strengthening of their financial base through the ample funds of the chartered banks, while the banks will gain from the capital markets expertise and the generally higher innovative spirit of the securities companies.

Abrégé

L'émergence de Tokyo comme place financière de premier ordre est l'un des phénomènes les plus notables de l'économie mondiale actuelle. L'installation au Japon des banques à charte et des compagnies de courtage canadiennes est relativement récente, et celles-ci ont à lutter pour se faire une place dans un marché dynamique et difficile.

Grâce à un taux d'épargne domestique remarquablement élevé, l'exportation des capitaux japonais s'est accrue à une vitesse étonnante; ainsi, pour la seule année 1985, elle dépassait 82 milliards de dollars américains en placements à long terme. Tout comme dans les années 60 et 70, quand le Japon était parvenu à la première place dans beaucoup de secteurs manufacturiers, il en est de même aujourd'hui dans le domaine financier: ce pays est en passe de devenir l'un des intervenants majeurs sur la scène financière internationale.

Les Japonais prennent peu de risques dans leurs investissements à l'étranger. Leurs capitaux, en général, s'investissent dans des économies stables, comme celles des Etats-Unis, du Canada et de l'Australie. Leur préférence va aux valeurs de portefeuille, quoiqu'une tendance non négligeable à investir directement sur les marchés étrangers se fasse également jour.

L'impact des placements japonais sur le marché canadien est profond. Le Canada est le pays qui reçoit le plus de ces capitaux par habitant. Le Japon est actuellement détenteur d'obligations des gouvernements fédéral et provinciaux, pour une valeur supérieure à dix milliards de dollars, ce qui représente une part considérable de la dette nationale, et il y a tout lieu de croire que cette tendance ira en s'accentuant. Les principaux investisseurs japonais en valeurs mobilières sont des institutions comme les compagnies d'assurance-vie ou les banques d'affaires qui gèrent les fonds de pension japonais.

Si ce phénomène profite à l'économie canadienne, il représente également des dangers. Entre autres, il est inquiétant qu'une énorme part de notre dette extérieure se trouve au pouvoir d'institutions d'un seul pays, ou encore que l'extrême liquidité des investissements japonais en valeurs de portefeuille laisse le Canada à la merci de retraits massifs soudains.

Les principales banques à charte canadiennes ont des représentants à Tokyo depuis de nombreuses années, mais la permission d'y établir des succursales ne date que de 1981. Malheureusement, les activités de ces dernières ont été plutôt décevantes jusqu'ici. Les prêts à grande échelle se sont révélés particulièrement difficiles au Japon : les banques japonaises ayant accès à d'énormes capitaux à des taux d'intérêts très bas, elles sont en mesure d'accorder des prêts commerciaux à des conditions bien plus avantageuses que celles que peuvent offrir la majorité des banques étrangères; de plus, les banques étrangères, canadiennes et autres, sont gênées dans leurs opérations par des traditions commerciales qui unissent étroitement les emprunteurs et les banques appartenant aux mêmes groupes industriels japonais. Le financement commercial procure un revenu modeste mais stable.

Les nouvelles activités sur le marché des devises et des capitaux paraissent beaucoup plus prometteuses pour les banques canadiennes, et ce du fait de la déréglementation progressive du marché financier de Tokyo. Un des objectifs principaux des banques canadiennes au Japon est donc de s'approvisionner à la source des capitaux bon marché pour financer leurs activités ailleurs. De nombreuses possibilités existent également dans le domaine des opérations d'arbitrage et de spéculation sur les monnaies et les taux d'intérêts, grâce à une grande variété de systèmes ingénieux d'opérations de report. Les efforts des banques canadiennes pour délaisser les activités commerciales traditionnelles afin de se réorienter vers les marchés de capitaux sont gênés à la fois par la réglementation du ministère des finances japonais, qui interdit aux insitutions

financières d'être en même temps banque commerciale et banque d'affaires, et par leur propre inexpérience dans les activités de banque commerciale au Japon.

Les maisons de courtage canadiennes ont bien réussi au Japon, ces dernières années, en grande partie parce que l'appétit des Japonais pour les investissements étrangers semble insatiable. Le gros de leurs activités demeure centré sur la vente d'obligations gouvernementales canadiennes aux maisons de placement japonaises. Ces dernières n'ont qu'un intérêt médiocre pour les actions canadiennes et, jusqu'à très récemment, les investissements canadiens au Japon étaient insignifiants. Bien que les maisons canadiennes dominent encore le marché des obligations canadiennes au Japon, leur position est menacée par la concurrence de plus en plus dure que leur opposent les courtiers japonais et étrangers, au Japon et même au Canada. Les compagnies canadiennes contre-attaquent en diversifiant leurs activitiés sur le marché de Tokyo, particulièrement dans le secteur des actions, des investissements privés et des opérations de report. Obligées d'investir d'énormes sommes pour s'équiper en matériel électronique sophistiqué et avoir un grand choix de valeurs mobilières en portefeuille afin de faire face à la concurrence, les compagnies canadiennes se trouvent défavorisées par leurs actifs qui ne représentent qu'une fraction de ceux de leurs principaux concurrents.

Toutes les maisons de courtage canadiennes faisant actuellement des affaires au Japon le font par l'intermédiaire de correspondants plutôt qu'à partir de leurs propres succursales. Bien que cela présente quelques inconvénients sur le plan commercial, leur petite taille et l'importance secondaire qu'elles accordent au marché des actions rendent improbable tout changement de leur manière d'opérer dans l'avenir immédiat.

Les banques et maisons de courtage canadiennes ont affaire à une concurrence de plus en plus forte sur la place de Tokyo, et leurs problèmes se trouvent aggravés par les coûts exhorbitants des loyers commerciaux et par la presque impossibilité d'attirer à leur service du personnel japonais de grande compétence.

La situation des institutions canadiennes au Japon se voit immédiatement affectée par la présente déréglementation du marché financier de Tokyo, on peut s'attendre également à ce que les changements que le Canada s'apprête à apporter à sa propre réglementation aient des répercussions majeures sur ces mêmes institutions. La nouvelle réglementation de la Commission des valeurs mobilières de l'Ontario et les amendements sur le point d'être apportés à la loi fédérale sur les banques permettront aux institutions financières étrangères, aussi bien qu'aux banques à

charte canadiennes, d'acquérir la propriété et le contrôle de compagnies de courtage canadiennes. Cette réglementation, quand elle sera en vigueur, constituera un défi dans le pays même pour les professionnels canadiens des valeurs mobilières. Mais elle leur fournira également de nouvelles occasions de s'implanter dans les principaux marchés étrangers, comme celui de Tokyo. La nouvelle réglementation canadienne facilitera d'abord les accords d'entente entre les courtiers canadiens de faible envergure et des firmes étrangères puissantes à la fois sur le plan financier et sur celui de l'expertise. Elle permettra en outre l'acquisition de compagnies de courtage par les banques à charte canadiennes, renforçant ainsi ces deux types d'institutions et leur donnant une meilleure efficacité face à la concurrence internationale. Les compagnies de courtage bénéficieront, dans ce processus, des fonds importants dont disposent les banques à charte, tandis que celles-ci profiteront de l'expertise des compagnies en matière de marchés de capitaux et de l'esprit d'initiative qui généralement les caractérise.

Introduction

The liberalization of the Japanese financial markets is having an enormous impact on countries and financial centres throughout the world. A vast amount of excess capital, coupled with ongoing changes to a heretofore insular financial system, have resulted in Japan's becoming one of the most exciting and potentially lucrative financial market places in the world. Despite the difficulties of conducting business in a society characterized by its high degree of xenophobia, North American and European financial institutions are flocking to Tokyo. While current market players are looking for opportunities that will allow them to gain an edge in this highly competitive environment, others are hammering on legal and regulatory doors in an effort to broaden the rules of the game of financial intermediation.

Canada is a small player in this highly sophisticated and international market place, yet its financial institutions are committed to pursuing and developing this new avenue of growth. The purposes of this report, then, are to present an overview of the financial relationships between Canada and Japan, and to examine specifically the role of Canadian banks and securities companies in the Japanese market. The topics are developed within the context of Japan's global capital surplus position, the increased liberalization of the Japanese and Canadian financial markets, and the general trend toward securitisation. In addition to outlining the history and current

status of Canadian financial institutions in Japan, the report provides policy recommendations designed to enhance their position in the dynamic Japanese financial market.

Japan as the World's Largest Capital Exporter

Financial relationships between Canada and Japan must be viewed within the context of Japan's massive global capital export position. This capital outflow has grown at a truly astonishing rate. Table 1 illustrates the development of Japan's economy from that of net capital importer in the early 1960s to the recent phenomenon of wholesale capital exporter, eclipsing even OPEC at its heyday. Indeed, what OPEC achieved over a century through the role of supplier of the main fuel of the world's growth, Japan has achieved in thirty years from the rubble of a defeated nation, with no indigenous resources, as a small island nation at the other end of the economic world, through a policy of export-led growth. Furthermore, the Japanese have shown an ability both to target certain industrial sectors, and to change those targets as their comparative advantage is lessened, as OPEC attempted but did not entirely succeed in doing, thus eliminating over-reliance on one sector for economic growth. By far the most dynamically expanding business sector in Japan at present is the financial services industry. Just as Japan achieved world pre-eminence in manufacturing industries such as autos and electronics during the 1960s and 1970s, it is now poised to become the dominant player on the global financial scene, with far-reaching implications for governments and financial institutions everywhere. As there are few signs of any significant long-term faltering in the Japanese economy, it appears quite

likely that Japanese capital exports will continue unabated for the foreseeable future.

Sources of Capital Accumulation

Explaining the recent phenomenon of massive Japanese capital exports requires firstly an understanding of the extraordinarily high savings rate in Japan. At 17% of disposable income, the Japanese savings rate is the highest in the world, over four times that of the U.S. (See Figure 1 for comparative data). Undoubtedly, Japanese culture plays a major part in this eagerness to save. The Confucianist ethic of thriftiness underlies the Japanese way of life. And centuries of survival on severely crowded islands with few natural means of support have taught the Japanese to sacrifice or defer personal pleasure in the form of a higher standard of living in order to benefit the larger group, be it the family, the company, or the country.

Other significant causes of the Japanese savings habit include the importance which the Japanese attach to education, and the lack of adequate retirement pensions. As a culture, the Japanese place a very high emphasis on the education of their children. From an early age, Japanese children spend countless "free" hours in private tutorials and special classes designed to supplement their basic education. This amounts to years of additional intensive studying far beyond that required in any western country. Parents must save in order to finance this as well as post-secondary education.

Furthermore, the lack of adequate public pension schemes forces Japanese wage earners to put away a significant portion of their earnings to provide for retirement. The Japanese have the fastest aging population in the world, and the inadequate public pension programs necessitate the accumulation by individuals of large sums of money for comfortable retirements, the cumulative effect of which represents a massive hoarding of capital.

Finally, government-imposed savings incentives were used to great advantage after World War II to supply the funds necessary for rebuilding the Japanese economy. At that time, Japanese industry required massive inflows of capital to finance the reconstruction effort after the destruction brought about by the war. Such heavy "smokestack" industries as steel making and vehicle manufacturing were highly capital intensive. The Japanese government assisted in mobilizing savings through a system of incentives designed to render deposits in specific types of accounts an irresistably more attractive use of funds than consumption. The main measure was to free certain types of savings accounts from tax, the most notable still in existence

today being the postal savings system. Through such measures, the Japanese government was able to wring every bit of frugality it could out of the Japanese population at a time when it was needed the most.

Reasons for Capital Surplus

Today, the Japanese economy no longer requires such high levels of savings for investment in Japan, and yet the high savings rate persists. Japanese industry is becoming increasingly cash-rich, as the pace of growth in Japan inevitably slows down from the break-neck pace of the past few decades, and the astute investments and large recently-won market shares transform themselves into healthy profits and positive cash flows. Furthermore, the type of new investments being made in Japan, although still substantial in size, cannot compare in capital requirements to the heavy industries of the 1950s and 1960s. Accordingly, as high Japanese savings rates persist, the coffers of the nation are beginning to overflow. For example, the previously-mentioned Japanese postal savings system has grown into a financial organism of truly mammoth proportions: deposits accumulated through its 23,000 postal outlets equal over US$550 billion[1], making it by far the largest body of savings in the world, greater than the four largest commercial banks in Japan combined.

A separate but related factor in Japan's capital accumulation is the ever-increasing Japanese trade surplus. Figure 2 shows the Japanese current account balance for the years 1974-1984. It is notable that even after the oil shocks of 1973 and 1979, the Japanese economy quickly recovered to very solid current account surpluses. A near-mirror image of the current account balance is the net capital outflow superimposed on the same graph (Figure 2). It is not at all unusual that an island nation such as Japan has emerged as a nation so entirely dependent on exports. As a country with few natural resources save an educated, thrifty population, Japan's economic survival depends to a large extent on its ability to import raw materials and semi-finished products, perform high value-added operations, and export the finished products. The Japanese have been particularly astute at promoting exports while at the same time inhibiting imports through barriers to entry or through nationalistic behavior on the part of the Japanese consumer. The large volume of trade which is transacted in non-yen-denominated currencies has become an enormous source of foreign capital which must sooner or later be used either to buy imports, or to buy foreign securities or factories.

Exporting the Surplus

As a consequence of all these forces, the Japanese have a problem in finding a profitable home for their cash. They have, basically, three possible alternatives. The first is to effect a change in the personal spending habits of the Japanese population, both in terms of increasing consumption of imports at the expense of domestically produced items, and in terms of increasing consumption in general. In fact, this has been halfheartedly tried through the active promotion of "buy imports" policies by politicians, with very little success. Changing personal spending habits is a difficult proposal at best, which is compounded by the twin problems of providing for retirement and the education of children.

A second alternative use for the excessive amounts of capital is in public spending on social infrastructure and the like. Foreigners are often surprised to learn that for all their economic might, the Japanese live all too often in what has been described as "rabbit-hutch housing," and do not always have the basic water and sewerage systems taken for granted in the West. Although such opportunities for public spending abound, there is already a massive government deficit in Japan, with little prospect for further substantial increases in public spending.

Therefore, the third alternative – wholesale capital exporting – is the only remaining use for the Japanese capital surpluses. Furthermore, the likely results of *not* exporting the excess capital are just as important as the reasons *to* export it: the effect on the value of the yen, unemployment, and inflation. As a trading nation, Japan is very dependent on exports as a source of profits and growth. A cheap or under-valued currency is a prerequisite for healthy exports. If the Japanese wished to retain their capital surpluses in Japan for use at home, it would require the exchange (sale) of export-earned dollars into yen. The result would be a decrease in demand for dollars and an increase in demand for yen, causing the value of the yen to rise further, with the resultant loss of the cost advantages of many Japanese exports. Industrial output and growth would fall as the loss of exports caused a ripple effect throughout the economy, with attendant unemployment and hardship, especially in the small-business sector. The increased surplus of yen would also expand the Japanese money supply and increase the rate of inflation. Accordingly, having recognized the necessity of exporting capital, the Japanese, in characteristic fashion, are pursuing that objective with a vengeance.

Foreign Investment Characteristics

As sources of capital in Japan have risen inexorably over the past decade while opportunities for investment in Japan have dwindled, the stream of capital to the West has become a tidal wave, with US$82 billion of Japanese long-term capital flowing overseas in 1985, up from about $57 billion in 1984 (Table 2).

In making their overseas investments, the Japanese are characteristically low-risk takers, both in terms of the location of investment and in terms of its form. Accordingly, only countries with the highest ratings of creditworthiness have been chosen as suitable for investment. The United States has accounted for by far the majority of the investment, with most of the remainder going to the other traditionally stable countries of Canada and Australia. It is interesting to note that the Japanese have largely avoided the pitfalls of Third World lending that have plagued so many Western bankers in the recent past. In the late 1970s, a few Japanese banks took large losses on loans to Iran and other less-developed countries, and it is apparent that the Japanese have learned their lesson well and now view security as a critical factor in making their international investment decisions. This policy of avoiding loan default at all costs is perhaps due to Japanese fear of jeopardizing pension assets, and may explain why U.S. and other foreign securities are gobbled up even with the prospect of continued devaluation of the dollar.

The form of investment abroad exemplifies the Japanese low-risk policy and penchant for highly liquid securities such as bonds or publicly traded shares. In 1985, some $54 billion of the total $81 billion invested abroad was in the form of U.S. Treasury bonds. Table 3 shows the breakdown of Japanese foreign securities investment between stocks and bonds through July 1986. When the Japanese do invest in equity at all, they have shown a distinct preference for portfolio ownership of equity in foreign firms over direct investment, reasoning that it is preferable to own the stock of a foreign firm than to make an investment in concrete and steel.

There is evidence that equity will become an increasingly common form of investment abroad by Japanese investors. One argument for such a shift is that, as financial markets and consumers in Japan become increasingly sophisticated, the Japanese individual will be able to get, and will demand, higher returns than the very low yields (usually 4-5%) available on government-encouraged domestic deposits. Political pressure from Japan's trading partners are also forcing more Japanese investors into direct investments overseas.

The Position of Canada

Although much has been written regarding Canada's trade relations with Japan, little has been said about the implications of the increasingly significant role that the Japanese are playing in Canadian financial markets. It is estimated that Japan currently holds in excess of $10 billion in Canadian federal and provincial government bonds[2], a significant portion of the national debt. This amount has increased approximately 70% over the last five years, and is likely to continue its explosive growth into the 1990s. Coupled with direct investment in Canadian plant and equipment, the economies of Japan and Canada are becoming increasingly linked, with Canada dependent on Japan for much of the financing of its economic growth. Table 4 shows the total amount of yen borrowings by Canadian entities as of March 1986.

It must be emphasized here that the full magnitude of capital flows from Japan to Canada is extremely difficult to assess. Although much of the Japanese investment in Canadian bonds is placed directly through Canadian securities firms, a large portion comes to Canada indirectly through the U.S. or Europe, and thus is not identified as Japanese investment in statistical records. It is, however, estimated that 28%, or some US$11.4 billion, of Japan's US$40.8 billion investment in foreign securities in 1984 was channelled into Canada. This compares to 40% for the U.S. and 22% for Australia.[3]

Nature of Japanese Investment

The main Japanese investors in Canadian securities are institutionals such as insurance companies and trust banks. Recently, the Postal Life Insurance Fund, Japan's largest domestic institutional investor, has also moved into the international investment arena.

An example of the huge flow of Japanese investment funds to Canadian instruments is provided by Dai-Ichi Mutual Life Insurance Company, which, at the end of March 1986, had a total of US$1.9 billion invested in Canadian securities. This figure represents 44.8% of the 9% of its total assets that Dai-Ichi currently holds in foreign investments. Of its US$1.9 billion holdings of Canadian securities, US$1.66 billion is in Government of Canada bonds. Similarly, Nippon Life Insurance Co. holds close to 30% of its foreign investments, or US$1.2 billion, in Canadian government bonds.

Canadian bonds remain among the most attractive for Japanese instutitional investors, who generally take a conservative, long-term view. Canada fares extremely well from this perspective, with abundant resources, a sound economy, and negligible political risk. Canada's close relationship with the U.S. is also viewed favorably by the Japanese.

An added feature of Canadian bonds is that they are unlisted, unlike most other foreign sovereign bonds. Japanese life insurance investors can hold Canadian bonds at book value, provided currency changes do not exceed 15%. If such a change occurs, bonds must be revalued to market value. The recent net drop in Canadian bond holdings by Japanese investors (the first in four years) can be attributed to fluctuations in exchange rates which exceeded the maximum allowable 15%. The subsequent revaluation of bond holdings to market value resulted in huge currency losses for Japanese institutional investors. Similarly, as oil is perceived to be an important part of the Canadian economy, the recent decline of oil prices, coupled with the unstable dollar, resulted in a temporary "cooling of the heels" by Japanese investors.

Outlook

Until April 1986, Japanese life insurance companies were limited in the amount of their holdings of foreign securities to 10% of their total portfolio. As can be seen from Table 5, the amount of foreign securities holdings as a percentage of total assets for the industry as a whole at the end of 1985 was very near the 10% ceiling. Since April 1986 the limit has been raised to 25%, although now included in this ceiling are holdings of sushi bonds

(foreign currency bonds issued by Japanese corporations in the Eurobond market). In real terms, the new limit raises the effective ceiling on holdings of foreign securities by an additional 4-5%. Unlike the life insurance industry, the postal savings group had, until recently, taken a more cautious approach to foreign investment, and is still a long way from reaching its 10% limit. Its foreign bond holdings for the year, to April 1987, are expected to reach US$3.7 billion, double the figure of the previous year.[4] Thus, there still remains room within the existing regulatory constraints for substantial further increases in Japanese institutional holdings of Canadian securities.

Canada will almost certainly remain among the most attractive locations for Japanese institutional investors. As long as yield differentials continue to be attractive, Japanese capital flows to Canada are unlikely to abate in the near future. The direction and magnitude of the flows will, however, be tempered by changing yield spreads, country risk assessments, and diversification needs. Dai-Ichi, for example, is now moving to reduce its holdings of Canadian dollar bonds to a more diversified level of around 30%. They plan to do this by reducing their purchases of Canadian bonds in fiscal 1986, rather than by selling off existing holdings. Similarly, Nippon Life is not interested at the moment in increasing the percentage of Canadian dollar bonds in its portfolio of foreign holdings.

Implications for Canada

On the surface, the prospect of continued massive inflows of Japanese capital to Canada may appear to be an unqualified boon to Canadians: an open pipeline for financing the ongoing fiscal deficits of Canadian governments without undue upward pressure on domestic interest rates. But risks are present. First, is the enormous concentration of external financing sources in the institutions of a single country – particularly when, as explained above, the total magnitude of investment from Japan is impossible to measure under existing statistical processes. Second, is the high degree of liquidity of Japanese investment holdings in Canada. Characterized overwhelmingly by portfolio-type investments rather than by direct investment in plant and equipment, the Japanese holdings could be liquidated on very short notice for any of a variety of political or economic reasons. The huge amount of portfolio capital flowing from Japan places Canada in a highly vulnerable position. A sudden or extended slowdown in the flow of such a large source of funds would surely create immense problems for Canada, and a massive withdrawal could be catastrophic. The remarks of Jeffrey Garten, head of the

Tokyo office of Shearson Lehman Brothers Inc., probably applies even more to Canada than to the U.S.:

> As long as the U.S. takes more and more money from abroad, it is mortgaging its domestic economic decisions to foreign investors whose behavior could be fickle and irrational.[5]

Thus, as never before, Canada's domestic political and economic policies must be developed with a sensitivity to how they will affect Canada's position in the world capital markets in general, and its relations with Japan in particular.

Canadian Banks in Japan

While a handful of foreign banks have been in Japan for decades (e.g. Hong Kong Bank since 1867 and Citibank since 1903), the real foreign bank invasion began after World War II. The American banks came first, beginning with the Occupation. Successive waves of British, then German, banks followed, mostly during the late 1960s and early 1970s. As of mid-1986, 77 foreign banks had branches in Japan, and another 100 or so had representative offices. Yen-based lending by foreign banks' branches totalled Y5.5 trillion (US$ 27.5 billion), or roughly 2.7% of the total Japanese loan market.[6]

Late Arrivals

Canadian banks are among the most recent entrants. Because Canada's Bank Act excluded direct entry of foreign-owned banks in Canada until 1981, the Japanese Government similarly excluded direct participation by Canada's banks in Japan. All of the "Big Five" Canadian banks had set up representative offices in Tokyo prior to the Bank Act revision. But without branches or subsidiaries, they could not book loans in Japan, nor participate directly in other fee-based activities. The Canadian Bank Act revision of 1981 allowed Japanese banks into Canada for the first time. The Japanese Government reciprocally opened the doors of Japan to direct entry of Canada's banks.

The major Canadian banks had been clamoring for years for a direct presence in Japan, and most rushed to Tokyo at the first opportunity. Bank of Nova Scotia, Bank of Montreal, Royal Bank, and CIBC all opened Tokyo branches in 1981; Toronto-Dominion followed soon after in 1982. National Bank of Canada has also applied for branch status, with approval anticipated in early 1987. In addition to the chartered banks, one Canadian trust company – Royal Trust – operates a representative office in Tokyo through its London merchant bank subsidiary, providing mainly investment advisory and securities custodial services to Japanese investors.

Despite their eagerness to enter Japan, Canada's chartered banks have encountered intense competition there, as well as government controls and a tightly-knit business system that have rendered returns, for the most part, far below initial expectations. Published financial statements of Canadian bank branches in Japan, at March 31, 1986, are presented as Table 6.

Spread-based Activities

Spread-based activities of Canadian and most other foreign banks in Japan are, in the words of one senior Canadian banker, "a disaster." Problems abound on both the funding side and the lending side.

On the funding side, the underlying problem for foreign banks is clear: the Japanese banks' access to massive amounts of low-cost deposit funds. The Japanese, with the worlds' highest rate of savings, have traditionally placed most of their savings into very low-yield deposits at Japanese commercial banks or Japanese postal savings. While some foreign banks solicit retail deposits in Japan, they are an insignificant source of funding for most, including all of the Canadian banks, who must instead purchase funds on the money markets at substantially higher cost. It is mainly this large, stable, low-cost source of deposit funding which enables Japanese banks so often to price their commercial loans at rates below the *cost* of funds to foreign banks.

On the lending side, the constraints facing Canadian banks in Japan are more complex and diverse. Most of the largest and best-known Japanese companies – the very ones the Canadian banks would most like to lend to – are simply not borrowing from anyone, foreign or Japanese. Many are in highly liquid positions and have become, themselves, major suppliers of funds to the Japanese financial markets. Thus, Canadian banks have been forced to move down toward the middle market in their search for new customers.

Even where Japanese companies *are* in a position to borrow, formidable barriers to foreign banks are posed by the nature of industrial groups and traditional main-bank lending relationships in Japan. Most major Japanese companies belong to one of the huge industrial groups, or *keiretsu*, each centered around one of the major Japanese banks. Although group members are nominally independent companies, the bulk of their shares are held by other industrial or financial firms related to the same group. In its role as the "Godfather" of such a close-knit family of companies, the main Japanese bank at the center of each group may exercise a dominant influence over the borrowing and other financial decisions of its group members.[7] This is of critical importance to foreign lenders, as Japanese companies will necessarily turn first to their main bank and to their own industrial group. In the case of large borrowings, government-imposed lending limits as well as prudent financial management will often dictate borrowing from a variety of other lenders as well – but only with the advice and consent of the main Japanese bank.

Because of these unique circumstances, well over half of the lending of Canadian banks to Japanese companies is done by referral from the major Japanese banks. This has several important consequences. First, spreads on such loans are extremely low, because the basic lending rate will have been set by the lead Japanese bank in relation to its low-cost deposit funds. On the other hand, risks are also extremely low, as the main Japanese banks will already have screened the potential borrowers, and they implicitly (though not by legal compulsion) guarantee the security of loans made by the other participants. Finally, the access of Canadian banks to such referral lending in Japan is on a strict, though informal, *quid-pro-quo* basis for a corresponding value of business which the Canadian bank has obtained (or will get) for the lead Japanese bank, either in Canada or elsewhere.

Canadian banks have succeeded in generating some loans directly to Japanese companies, but here also difficulties abound. For the most part, Japanese companies in a position to borrow directly from foreign banks are second-tier companies, not affiliated with an industrial group. The problem here is essentially one of risk. Without the credit guarantees implicit in a main-bank referral, the Canadian bank must perform its own credit analysis based mainly on financial statement information, an extremely risky undertaking in Japan. The dilemma is obvious: those companies which you would want to lend to are already locked into very tight relationships with their main

Japanese banks; whereas most companies without main-bank relationships are probably higher credit risks. A classic case in point is the recent collapse of Osawa & Co., a large Japanese trading house. Foreign banks had lined up to lend to Osawa, which had no main-bank relationship with a Japanese bank, ignoring the obvious question of *why* the Japanese banks were not participating. When Osawa collapsed, the foreign banks were the main losers.

In summary, Canadian and other foreign banks have had little success in generating attractive spread-based activities in Japan. Even when lending activity is available, spreads are often too low for profitable operation. In the extremely competitive and restricted lending environment of Japan, the treasury function assumes particular importance. With lending rates so very low, the burden is on treasury to raise funds at low enough cost to be able to compete with the lending rates of the Japanese banks. This is especially difficult for Canadian banks, who are starting up operations with a high percentage of expensive expatriate staff. It appears, moreover, that the hurdle return-on-assets (ROA) requirements imposed by most Canadian banks may be inappropriate to the competitive environment of Japan. A key to any business activity in Japan is to work toward very long-term profit horizons by maximizing market share and building customer loyalty. If Canadian banks are to get anywhere with spread-based activities in Japan, they may need to reassess their traditional ROA hurdle requirements: in essence, accepting any loans that will at least cover costs in the short-run, in order to generate volume, increase size, and build durable customer relations which may lead to more satisfactory returns in the long-run.

Trade Finance

Virtually every Canadian bank in Japan has been successful in trade finance and it is expected that this area will continue to be an important source of revenue. Canadian banks realize significant earnings from letters of credit (L/Cs) opened by Canadian companies buying goods from Japan. This may take the form of commissions generated by documentary activity such as issuing, advising and confirming letters of credit, the negotiation of documents with or without L/Cs, the collection of drafts or cheques and the settlement of import bills.

Short-term credit relating to trade may be provided by export, import, or clean bills discounted in Tokyo. Also, yen bankers acceptances (BAs) may be created in Tokyo since this market has recently been allowed to function in Japan. (Yen BAs

are not yet, however, a substantial contributor to earnings due to the relatively low level of international trade financed in yen). In addition, long-term financing may be provided by the Export Development Corporation (EDC) at fixed, attractive rates of interest depending on the nature of Canadian goods and services to be exported. Foreign exchange business may also be generated by the needs of companies engaged in trade, such as yen payments made by Canadian importers.

The strength of the major Canadian banks' global network also facilitates trade by the Japanese to areas such as the Caribbean where Japanese banks are not well represented. Exports from Canada to Japan are controlled and financed almost exclusively by the large house banks of Japanese trading companies and corporations, and therefore offer more limited opportunities to Canadian banks.

Money and Capital Market Activities

Japan has become by far the world's largest source of surplus funds. One of the most important objectives of Canada's banks in Japan is to tap into this low-cost source of capital to fund their activities elsewhere.

The Japanese short-term money market is presently a hybrid of "free" and "regulated" interest-bearing financial instruments. As discussed earlier, Canadian banks have not been able to compete successfully with Japanese financial institutions for low-cost deposits, and have funded the bulk of their portfolios in the higher-cost wholesale market by accessing the call money or bill discount markets, or by entering into open market transactions on the gensaki (repurchase agreement), CD, or US dollar/yen swap markets. Table 7 presents a detailed list of alternative funding sources available to Canadian banks in Japan. Recent deregulation in Japan is making the domestic Japanese financial markets much more accessible to Canadian and other foreign banks. As interest rate ceilings on time and demand deposits in Japanese banks continue to rise toward market rates as a result of deregulation, the exclusive hold on large pools of capital at preferred rates which Japanese banks have enjoyed will continue to weaken, opening further funding opportunities to innovative Canadian banks.

Internationally, a wide range of new opportunities for currency and interest rate arbitrage and speculation exist for Canadian banks in Japan. In recent years there has been a marked increase in interest rate swaps with Canadian banks acting as both intermediaries and counterparties, depending on their global funding needs. Japanese banks and corporations

have been active in Hara-Kiri swaps, whereby Eurobond issues have been swapped into yen at rates substantially below the long-term Japanese prime rate. This has facilitated access to Japan's capital markets as well as access to foreign markets by the Japanese, and can be the source of substantial fee income to the banks. Co-ordination and communication between major international money centres, highly specialized personnnel, and the ability to recognize, understand, and react quickly to the needs of Japanese institutional investors (i.e. tax and reporting constraints, cost considerations and foreign exchange exposure) are critical factors for success in these activities.

Conclusions

The experience of Canadian banks in Japan has been sometimes difficult and often frustrating but they are clearly there to stay for no other reason than no bank today can claim world status without being in Japan. Earnings are possible, however, and useful lessons may be drawn from the experience to date.

Perhaps the most important lesson is the need for finding a niche. Even the largest Canadian banks are small players in the Japanese game, limited in both resources and experience. They cannot possibly compete effectively in all banking services. In general, those Canadian banks which have identified and pursued particular, distinctive market opportunities – e.g. swaps, private placements, funding arrangements etc. – have performed better than those which have attempted to compete in the full range of financial activities. An excellent case in point is Toronto-Dominion's Tokyo operations, which have focused largely on innovative funding arrangements, and which have generated by far the largest profits of any of the Canadian bank branches in Japan.

For those Canadian banks pursuing traditional yen-based corporate lending in Japan, there is a clear need for substantially longer return horizons than in most other markets. Corporate liquidity in Japan will remain high, and loan spreads very thin, for the foreseeable future. Nonetheless, it may be prudent to lay the groundwork now for eventual returns in the future by carefully and patiently building the stable, long-term relationships so essential to business and financial success in Japan. Such a long-term outlook may require that Canadian bankers lower their normal ROA hurdle requirements in Japan at least for the short term, which many are reluctant to do. Another prerequisite for generating profitable corporate lending business is the further development of a stable and highly competent team of Japanese account managers, as well as the

development of expatriates intimately familiar with Japanese business and culture.

While corporate lending will remain a staple ingredient of the services offered by most Canadian banks in Japan, a substantial and reliable source of earnings will continue to be trade finance, together with related foreign exchange and short-term financing activities. Other significant fee-based earnings will be generated from newer money and capital market activities, such as currency swaps and interest-rate swaps. A related thrust may be the use of Tokyo branches as a major source of funding for Canadian banks' operations elsewhere in the world. As Japanese corporations turn increasingly to direct financing via their own debt and equity instruments, some Canadian banks there will shift increasing priority to merchant-banking types of activities. Nearly all of these possibilities will be enhanced by the progressive decontrol of Japanese financial markets, already under way.

One of the most important internal needs is for Canadian banks to evaluate the performance of their Japanese operations in a much more global context. Spreads and fee revenues accruing directly to the Tokyo branches may seem small in relation to the effort required and to the high fixed costs involved. Yet the Japanese presence may yield substantial ancillary benefits elsewhere in the corporate network, benefits sometimes not fully captured and recognized in existing management information systems. Such ancillary benefits may include earnings from loans made to Japanese companies in Canada and elsewhere outside of Japan; revenues from letters of credit and other trade finance instruments relating to Japan but opened elsewhere; and sourcing of low-cost Japanese funds for use in other regions. Thus, Japan may warrant continued priority attention and high-quality staffing, even though the rewards may not be immediately apparent.

Japan is going to remain an intensely competitive and challenging environment for Canadian banks. Returns may be slow in coming and they may be difficult to measure fully. But as decontrol proceeds, Tokyo will become the dominant financial center in one of the most economically dynamic regions of the world. Canada's banks are still gaining valuable experience there. They need more careful positioning and more effective global coordination. As this is accomplished, Tokyo is likely to emerge as one of their most important markets.

Canadian Securities Companies in Japan

Although most Canadian securities companies are capable of handling securities transactions with Japan, only four of them have representative offices in Tokyo: Wood Gundy, Richardson Greenshields, Macleod Young Weir, and Dominion Securities Pitfield. In addition, the London merchant bank subsidiaries of the Royal Bank of Canada (Orion Royal) and the Canadian Imperial Bank of Commerce (CIBC Ltd.) have established securities representative offices there. All are seeking to position themselves to take advantage of Japan's seemingly unquenchable thirst for foreign investment opportunities. Discussions by the present authors with Canadian firms about their activities in Japan reveal a cloak of secrecy and a reticence to divulge information that is astonishing in its degree, suggesting not only that the market place is extremely competitive, but that Canadian firms are serious in their battle for increased market share.

Wood Gundy, Richardson Greenshields and Dominion Securities Pitfield established representative offices in Tokyo in 1973 in response to the increasing internationalization of the financial markets. All had representation in Europe as well, and Tokyo was the next logical step in an overall strategy that called for an international presence in the bond and money markets. These Canadian firms were among the first of the foreign securities companies to penetrate the Tokyo market, a movement

which began in 1971. The vast majority of foreign representative and branch offices were opened after 1981. Macleod Young Weir was part of this secondary wave of interest, establishing a representative office in April 1986. As of June 1986, a total of 23 foreign securities companies had branch offices in Tokyo, all but three of them established after 1980, and another 102 foreign firms had representative offices there.

Equity Market Activities

For most of the early entrants, the first few years in Tokyo were not very profitable, due mainly to the oil crisis of 1973, which resulted in Japan reducing its foreign investments. During the period 1975-1978, Canadian resources were booming and the Canadian securities firms were able to enter the equity market through selling Canadian stocks to Japanese institutional investors. Since the early 1980s, however, with commodity prices down and the Canadian economy suffering the effects of the 1981 recession, the equity side of the business has been very small. Nonetheless, Canadian firms are optimistic that recent developments in this market will continue to burgeon. Evidence of a change in investment orientation is already being felt in the United States, and the current rush by Japanese institutional investors to buy U.S. stocks is resulting in some spill-over for Canadian firms. Indeed, all the Canadian representative offices report a recent increase in their equity trading activities.

The increased institutional demand for foreign equities has been driven in part by the growing popularity of foreign stocks with cash-rich individual Japanese investors, seeking benefits accrued through tax breaks, low price/earnings ratios and higher dividends. In fact, the Tokyo branch of Nikko Securities Co. recently reported more business in foreign stocks than in Japanese stocks.[8] The stocks of well-known companies which have a strong presence in Japan are the most popular, especially companies such as MacDonald's, IBM, and Disneyland. Securities firms are bullish that the trend will continue. Foreign stocks listed on the Tokyo Stock Exchange (TSE) are expected to be especially attractive to Japanese investors in the future since the ceiling on foreign equity holdings imposed on Japanese institutional investors does not apply to them. Brokers in Japan would thus like to see as many foreign stocks as possible listed on the TSE. Twenty-one foreign companies are presently listed on the TSE, including two Canadian companies, Bell Canada Enterprises and Toronto Dominion Bank.

Caution is needed, however, when viewing the long-term potential for Canadian firms to engage in stock brokering in

Japan. Some of the largest Japanese institutional investors are skeptical that Japanese demand for Canadian equities will result in substantial business for Canadian securities firms. They cite the thin market in Canada, the preponderance of relatively volatile resource-based stocks, and the lack of information on Canadian stocks as factors which hamper Japanese institutional demand. Indeed, trading international stocks requires a huge investment in research staff, computer software, sophisticated information dissemination, and a strong presence in Tokyo, London and New York. It would thus appear to be a real challenge for Canadian firms to compete in the Japanese equity market against the large Japanese and foreign houses, with their extensive electronic networks and information banks for providing timely information to, and arranging deals for, their clients.

Nevertheless, Canadian firms are experiencing some growth in equity sales of U.S. stocks and a selected number of non-resource-based Canadian stocks, areas where they are able to provide timely information on a competitive basis. The major complaint heard from Japanese investors is the lack of visibility of Canadian companies in Japan, which, it is felt, contributes to reduced interest in Canadian stocks, especially at the retail level. It would thus appear that marketing programs are needed in order to increase Japanese institutional awareness of Canadian equity investment opportunities. Encouraging more Canadian firms to list on the TSE and to partake in investor relations programs could be important in raising the profile of Canadian corporate stocks in the Japanese market.

Along with the surge in Japanese interest in foreign stocks, foreign trading in Japanese stocks is also growing, with purchases in 1985 of US$ 4.1 billion and sales of US$ 3.56 billion, a 50% increase in net purchases over 1984.[9] Despite this global trend, Canadian investors have yet to take a major interest in Japanese stocks, with 90% of all Canadian overseas investment still going to the United States. This apparent lack of interest in Japanese or other foreign stocks suggests a strong domestic orientation among Canadian individual, corporate and institutional investors which may further constrain the relative position of Canadian securities companies in Japan. Despite their rather parochial perspective, Canadians, like Japanese, have a high personal savings rate which could be used to advantage. Attractively packaged and promoted foreign stocks might entice timid Canadian investors into the international markets and allow Canadian securities firms to diversify further into the Japanese equity market, with obvious resultant benefits.

Bond Market Activities

An earlier section of this report discussed the massive flow of Japanese capital to Canada via purchases of Canadian government bonds by Japanese institutional investors. Canadian securities companies have, for the most part, been concentrating their resources vis-à-vis Japan on the Canadian federal and provincial government bond markets. Although the Canadian firms interviewed in the present study were extremely reluctant to discuss dollar or volume figures which would help in providing an estimate of the extent of Canadian participation in the bond market, most acknowledged that the bulk of their business dealings with the Japanese is in bonds. Ninety to ninety-five per cent was the proportion quoted by one of the Canadian firms, and both Nippon Life and Sumitomo Life stated that close to 80% of their government bond deals with Canada involve placement with a Canadian securities firm.

The nature of the Japanese bond market is becoming increasingly sophisticated and complex as financial liberalization proceeds in Japan. The vast assortment of bonds, the increasing number of intermediaries competing for a piece of the action, and the huge sums of money being traded daily make conceptualization of the capital flows almost mind-boggling. Although adding to the confusion, the creation of new bond types has enabled greater access to Japanese capital for Canadian and other foreign borrowers. Currently, the following major bond types are actively traded:

SAMURAI BONDS – Yen-denominated bonds by foreign issuers.

DUAL CURRENCY SAMURAI BONDS – Samurai bonds in which the subscription costs and interests are payable in yen, but at maturity, the principal is repayable in a foreign currency.

SHOGUN BONDS – Dollar-denominated bonds floated in Tokyo by a foreign borrower.

SUSHI BONDS – Foreign currency bonds issued by a Japanese corporation in the Eurobond market.

The development of the market for samurai bonds is an important example of the increased liberalization that has come to represent a significant portion of the world capital market, particularly with respect to Japan. The first issue of samurai bonds occurred in 1970, but due to the 1973 oil crisis and the subsequent economic slowdown, the samurai bond market did not

get the full go-ahead from the Japanese Ministry of Finance (MoF) until 1977. As interest rates in Japan have remained below those in other capital markets, foreign borrowers have been eager to enter this market.

In response to criticism from abroad, the MoF moved in 1982 to remove the queuing system that many felt restricted the free issuing of samurai bonds. Instead, requests for issues are now submitted on a quarterly basis and issues are made for as much as the market can bear at a time. In addition, April 1983 saw quantity restrictions removed from private issues, and in contrast to earlier practice, unsecured private bonds are now freely accepted.

Between 1980 and 1986, Canadian federal and provincial governments and crown corporations issued Y170 billion worth of samurai bonds in the Tokyo market, representing 4.5% of the total market.[10] As foreign borrowers generally have little need for yen, most of these bonds today are immediately swapped into Canadian or U.S. dollars through the so-called "hara-kiri" swaps, discussed earlier. Currency swaps emerged as a major force in 1984, when the real demand rule on forward foreign exchange dealing was removed. Increasingly, due to the highly competitive environment and the desire of Japanese firms to increase their market share in the Euromarkets, spreads on swaps have been reduced to near-suicidal levels.

The Question of Status

All of the Canadian securities firms with offices in Tokyo operate there under representative rather than branch status. To achieve branch status, a firm must comply with regulations which stipulate a minimum of 20 staff, several years experience as a representative office in Tokyo, and national status in the home country. Some observers feel that their representative status places the Canadian houses at a competitive disadvantage vis-à-vis their Japanese and other foreign competitors, as representative offices are prohibited from holding securities or from receiving money directly. The disadvantages appear less severe in the bond market than in the equity market, as a representative office can act as an effective liaison between institutional borrowers in the home country and Japanese investors. On the Japanese equities side, however, representative status means that Canadian firms must place their orders through a Japanese or one of six foreign brokers in Tokyo, at very high commission rates. Similarly, the "*persona non grata*" position of a representative office requires that all securities and money be held offshore.

Representative status does, however, provide a relatively low-cost way of penetrating the Tokyo marketplace for smaller firms such as the Canadian houses. Despite the fact that the Japanese Ministry of Finance limits the type of institutions with which representative offices may deal directly (these institutions are all financial in nature and are limited to life insurance companies, trust companies and banks), non-specified institutions can also be contacted provided that a Japanese securities company is used as an intermediary, or that the deal is placed offshore.

Similarly, as Canadian securities firms at present neither have the capabilities nor express the interest in pursuing Japanese equity trading, the high commission fees for representative offices is of little impact. What is important, however, is the ability to anticipate and capitalize upon opportunities in the market. In such an environment, relationships cultivated by the representative office are a critical factor in gaining access to the entire market. Bilingual staff, both Japanese and foreign, is essential if such relationships are to be promulgated.

It is, of course, possible for a Canadian securities company to be actively involved in the Japanese market without a direct presence in Tokyo. The best case in point is probably Burns Fry, which handles a substantial portion of Canadian bond sales to Japan without an office there. Burns Fry's position is that they can adequately service the market without having to incur the high costs of operating a representative office in Tokyo. The other firms, however, feel that a direct presence in Tokyo has facilitated their business and has enabled them to get involved in more private placement deals, which would not be possible to do from Canada. A direct presence improves their access to current information, enables them to develop more and better contacts, and establishes an international presence that will benefit their operations worldwide.

Competitive Responses

Japanese institutions continue to invest heavily in the Canadian domestic bond markets, on both a primary and secondary basis. Samurai bonds, yen private placements, and swap deals are also involved with increasing frequency. As liberalization proceeds, the sophistication with which both borrowers and lenders participate in the market is growing dramatically, creating both new challenges and new opportunities for Canadian securities firms. An example of the former – and a highly contentious current issue – is the growing tendency for Canadian provinces to

raise money in Tokyo through loans rather than bonds, and through direct private placements, thus bypassing the Canadian financial intermediaries.

Although the Canadian securities firms play a dominant role in the Canadian bond market in Japan, the competitive environment is such that they may be hard pressed to maintain their current position (a view shared by some of the Japanese institutional investors interviewed in the present study). While U.S. houses occasionally take positions in Canadian government bonds, the market has until now been left largely to the Canadian firms. This is changing, however, with foreign entrants on the increase. Nomura Securities Co. is in the process of upgrading its Canadian office from representative status to a fully-incorporated Canadian company, and has begun to compete actively with Canadian houses for Canadian government bond issues. Continued deregulation of the domestic Canadian financial environment will likely result in more foreign entrants, and consequently increased competition at home.

While Canadian firms have so far held their own in Canadian bond transactions, many of their Japanese and American competitors are much more highly capitalized, and consequently able to hold larger securities inventories and to compete with lower prices. As an indication of size differences, the total capitalization of the entire Canadian securities industry is approximately $1 billion, while the capitalization of just one of the four largest Japanese securities companies, or any one of the two or three largest U.S. competitors, is over $2 billion. This poses a major challenge to the Canadian houses. Any dealer seeking to operate on an international scale in today's environment needs the ability to execute orders and to deal in *all* of the major world financial centers, as well as to manage interest rate swaps, hedges, and a variety of other complex transactions, all of which require an enormous investment in overseas offices and telecommunications systems. Moreover, as the nature of their business shifts increasingly from *agency* to *principal*, dealers will need even larger equity resources to hold major positions on their own account. A.G.E. Taylor, chairman of McLeod Young Weir, estimates that by the end of the current decade, a minimum capital base of some $500 million will be needed to compete effectively on an international scale.[11] Some of the Canadian firms are moving to meet this challenge by expanding their capital base. As examples, Wood Gundy and Gordon Capital came close to merging in 1986, and several other Canadian houses have made public share offerings, the most

prominent being the recently-announced public offering of nearly $100 million worth of shares of Dominion Securities Pitfield.[12]

The Canadian securities companies are also moving aggressively to broaden their activities in the Tokyo market, a strategy that will be essential for survival, not just in Tokyo but around the world. Wood Gundy is the only Canadian company in Japan with less than half of its Tokyo office activity related to the Canadian government bond market. As well as being active in the bond market, Wood Gundy is concentrating also on swaps, private placements, equities, new issues, etc. This seems indicative of the new directions in which the Canadian, like other foreign securities firms, are now moving. Dominion Securities Pitfield and McLeod Young Weir are now involved in swap deals, and Richardson Greenshields is moving more strongly into equities.

Intense competition faces the Canadian securities firms in Tokyo at every turn. Even finding appropriate office space can be an exhausting and challenging process. Office space is extremely difficult to find in the "good" areas of Tokyo (i.e. the Ginza and Marunouchi districts), particularly in the relatively small sizes needed by the Canadian firms. High overhead costs of running a representative office can place tremendous pressure on foreign firms to develop contacts and create business deals as quickly as possible. Estimated costs range from CAN$1-2 million per year to support a representative office with a staff of five to ten people (typically two Canadians and the rest Japanese), to at least CAN$4-5 million per year to support a branch office. Given such high costs, and the relatively minor advantages attainable through branch status, it is not surprising that branch status has not yet been sought by Canadian firms.

The Canadian investment firms, like other foreign houses, have also found it difficult to find good quality Japanese staff, given the lifetime employment culture in Japan. The situation is, however, slowly improving through offering salaries and bonus systems that are considerably more attractive than those given by their Japanese counterparts. As competition increases, the costs of maintaining good staff are expected to rise further, increasing overhead costs and placing additional pressure on firms to increase their level of business activities.

The Challenge of Deregulation

The competitive environment of Canadian financial institutions in Japan will be influenced profoundly by regulatory changes taking place both in Japan and at home. Earlier sections of this report described the impact of Japanese financial deregulation both on the banking industry and on the securities firms. Perhaps the most far-reaching consequence of deregulation, however, is the blurring of the traditional lines of distinction between the activities of bankers and dealers. As the world of finance becomes increasingly securitized, corporate financing is moving from bank loans to debt securities, with bank credits being traded as securities. For example, the recent rise in "transferable loans," i.e. banks selling loan credits to third parties on the market, is basically the same as underwriting debt securities. Nobuya Hagura, president of the Federation of Bankers Association of Japan, is convinced that in the long run these distictions will be further blurred:

> As Japan further deregulates its financial institutions, there will be increasingly little point in both bankers and stock brokers sticking to their own business territories, because customers will require a wider range of services.[13]

Continued moves toward financial market deregulation on both sides of the Pacific will significantly influence the competitive positions and strategies of all of Canada's financial service companies in Japan.

Deregulation in Japan

Although deregulation is being introduced to Japan gradually in a series of phased steps over time, Japan has a much more liberalized financial services market today than it had 10 years ago. The trend toward decontrol will certainly continue into the future. The status of Japanese financial market deregulation as of August 1986 is summarized in the Appendix. Some of the consequences and implications are discussed below, particularly as they affect the blurring of the traditional lines of demarcation between the commercial banking and securities industries.

Securities companies in Japan have, since April 1985, been permitted to engage in lending activities, using domestic government bonds as collateral. At the same time, regulations regarding certificates of deposit (CDs) have been eased, and securities companies are now able to buy and sell domestic CDs, foreign CDs, and commercial paper. As of April 1986, they also have access to the yen-based bankers acceptance market. Brokers have also penetrated the banking area through their overseas involvement in investment banking. Nomura Securities Company has even obtained a commercial banking license in London, as Daiwa Securities has done in Sydney.

On the banking side, Japanese banks started selling long-term government bonds and discounting government securities in October 1983. In June 1984, banks also began dealing in outstanding public bonds, and are now competing with securities firms for lead or co-lead managment positions for issues of yen bonds outside Japan. This marks the beginning of what some feel may be the end of the securities firms' domination of the domestic market. Banks are also having success in forcing the abolition of fixed brokerage commission levels in Japan, now among the highest in the world. At present approximately 40% of the income of the four largest Japanese securities firms is generated through brokerage commissions.[14] Removal of the fixed commissions will probably weaken seriously the profitability of some of the smaller Japanese brokerage firms. For foreign firms, however, it may increase their competitiveness. Fixed commission fees have acted as a huge cash cow to finance overseas operations of the large Japanese houses, giving them what many outsiders feel is an unfair competitive advantage.

Although legal distinctions between the two types of financial institutions remain relatively firm for Japanese companies (no Japanese financial institution is allowed to own more than a 5% equity position in another company), foreign institutions are having some success in circumventing the 5% ownership rule. European banks, operating in a regulatory environment that does not prohibit banks from engaging in underwriting activities, have been allowed to operate in Tokyo under the condition that they establish a separate securities subsidiary with no more than a 50% share of the total assets. Thus, Vickers de Costa, a U.K. securities wing of Citicorp, has been permitted to continue operations in Tokyo, despite the branch bank status of Citicorp in Japan. The Royal Bank of Canada and the CIBC are following similar suit through their London-based merchant banking subsidiaries, Orion-Royal and CIBC Ltd. Indeed, as liberalization proceeds, the key objective of securities houses is, as one Japanese executive stated, "for securities companies to get more banking and trust banking functions than banks get securities' functions."[15]

The driving force behind such liberalization is the realization that providing all-around, extensive financial services on a global basis is now the key to any financial firm's survival. As individual investors reduce their holdings with banks due to the higher returns of bonds, mutual funds, and other instruments, banks are also shifting their emphasis to move with the trend in the flow of funds. Japanese securities companies are encouraging link-ups with the banks, focusing on common credit cards and secured loans business. As stated above, Japanese banks are prohibited from buying their way into the securities business. Nevertheless, tentative negotiations between securities firms and banks are under way, and close ties already exist between the two sectors. As examples, Sumitomo Bank owns 3.5% of Daiwa Securities, and Nikko Securities handles underwriting for the Mitsubishi group. Similarly, Yamaichi Securities is linked with Fuji Bank and Mitsui Bank, and Sanwa Bank may link with Nomura Securities in the future.

The gradual but distinct trend toward securitization of the markets may make it increasingly difficult for smaller firms, such as the four Canadian securities companies in Tokyo, to enhance, or even maintain, their positions. The size, capital, expertise, and increased sources of funds of the large Japanese institutions will surely put downward pressure on bond prices and further reduce the already-thin margins. It seems safe to say that the natural consequence of Japanese financial market liberalization will be a major shake-out of the financial services

industry which could see smaller players, such as the Canadian, Australian, and smaller European firms, experience considerable difficulties.

In order to avoid being squeezed out of the market, it is essential that both the Canadian banks and the Canadian securities companies diversify their activities beyond their traditional areas, particularly given the rapid rate at which new instruments and ways of financing are becoming available. Canadian securities companies have an advantage over some of their competitors in the length of their experience in Japan, and the Canadian banks have advantages of size and global expertise. But some observers feel that Canadian financial institutions – both the banks and the securities companies – are handicapped in this new arena by the traditional separation of banking and securities functions at home in Canada, as neither group of institutions has had the opportunity to gain the breadth of financial expertise of some of their competitors, especially the Europeans.

Deregulation in Canada

Although the gradual but significant deregulation of the Japanese financial markets attracts the lion's share of international press attention, current steps toward financial decontrol in Canada itself will also have a profound influence on the competititve positions and strategies of Canada's financial service firms in Japan. Canada has a tradition of strong governmental regulation of financial services, at both the federal and provincial levels. These controls have had at least two major effects: (1) they have effectively precluded foreign ownership and control of Canadian financial institutions; and (2) they have maintained a strict segmentation of Canadian financial activities into the "four pillars" of commercial banking, investment banking/brokerage, trust banking, and insurance.

Unlike commercial banking, which is federally controlled, regulation of the securities industry in Canada falls under provincial jurisdiction. As some 90% of the Canadian securities industry is based in Toronto, this effectively means that the industry is regulated by the Ontario Securities Commission (OSC). Under its 1971 rules, which precluded a foreign dealer from owning more than 10% of a Canadian dealer, the Canadian securities industry grew in size and sophistication, but the number of foreign dealers operating in Canada shrank from 21 to four. Recognizing the incongruence of a protected Canadian industry in the face of increasingly globalized financial services and a breakdown of the traditional four pillars, the OSC

launched a major study of the industry in 1984.[16] As a result, Ontario is implementing measures to deregulate significantly its financial services environment. Although details of the final legislation remain in flux, as of this writing the following changes are anticipated:

(1) Effective June 30, 1987, ownership of Canadian securities companies by other domestic financial institutions may rise to 100%.

(2) Effective the same date, foreign ownership of domestic securities companies may rise to 50%.

(3) Effective June 30, 1988, foreign ownership of domestic securities companies may rise to 100%.

Accompanying revisions to the Federal Bank Act are also anticipated, enabling federally-chartered commercial banks to expand their activities and ownership into the securities business. This combination of steps, once fully implemented, will provide both major new challenges to the Canadian securities industry at home, as well as significant new opportunities to compete effectively in major overseas markets such as Tokyo. The new rules will facilitate the linkage of small Canadian dealers with major foreign firms with larger capital bases and global expertise. In addition, the large Canadian chartered banks will almost certainly move to acquire ownership positions in Candian securities companies, a move which should allow both types of institutions to compete more effectively abroad. The securities companies will benefit from the strengthening of their financial base through the ample funds of the chartered banks, while the banks will gain from the capital markets expertise and the generally higher innovative spirit of the securities companies.

Summary and Conclusions

The growth of Tokyo as a world financial center has been astounding. Having overtaken Singapore and Hong Kong as the Asian financial capital, Tokyo now challenges London and even New York. Although Canada's financial institutions are not key players there, Tokyo clearly holds a wealth of new opportunities, as well as formidable challenges, for Canadian banks and securities companies alike.

Three major developments in international finance are occurring simultaneously which dramatically affect the environment of Canadian firms in Japan: (1) the increasing globalization of world financial markets; (2) the trend toward securitization in corporate finance; and (3) decontrol of both the Japanese and Canadian financial markets. The more localized, protected, segmented markets in which financial institutions have been accustomed to operating are a thing of the past; the traditional lines of distinction among various types of financial intermediation are disappearing. As Canadian institutions seek to position themselves in the Japanese market, they face fierce competition and a bewildering array of new and evolving financial functions.

Implications for Canadian Banks

Canada's major chartered banks already possess the size and global expertise to compete effectively in world markets. While

spreads on commercial loans in Japan will remain extremely thin, most of them will continue to pursue Japanese corporate lending, if for no other reason than to develop long-term customer relations which may ultimately generate other, more lucrative lines of business. Domestic lending in Japan will, however, require the Canadian banks to accept substantially lower ROA hurdle requirements than they are accustomed to elsewhere. Trade financing will remain a stable and substantial flow of earnings. But the real challenge for Canadian banks in Japan will be to move beyond their traditional commercial banking activities, where Japanese financial institutions have a well-established edge, and into newer, creative money and capital market activities. With the enormous potential for using Japan as a low-cost source of funding, the treasury operations of Canadian banks in Japan will likely assume paramount importance, as will related currency and interest-rate swap activities.

Given the trend toward securitization in international finance, the main long-run growth opportunities for Canadian banks in Japan are clearly in the direction of merchant banking and related capital market activities. In this respect, the Canadian chartered banks may be at a handicap vis-à-vis those of some other nationalities as a consequence of the traditional lines of demarcation between various types of financial institutions in Canada, which has hindered their ability to acquire the same breadth of financial expertise which many of their global competitors have. Regulatory constraints impeding the integration of commercial and merchant banking activities both in Canada and in Japan will undoubtedly ease with time, expanding the opportunities for Canadian commercial banks to gain direct access to the experience and innovativeness of Canadian or other investment firms by mergers or acquisitions. The banks can, in the short term, gain expertise by participating more actively in the market for Canadian bonds in Japan. But for more substantial involvement in the Japanese capital market, the next logical step for the Canadian banks is to acquire their own securities subsidiaries, such as Royal Bank and CIBC have done. Indeed, it is not inconceivable that as the importance of securities activities increases relative to that of traditional commercial banking functions, some Canadian banks in Japan could seek to downgrade their Tokyo banking offices to representative status, thereby opening the way for direct branch status in Tokyo for their merchant banking affiliates.

It seems possible also that the Canadian banks could enhance their collective position in Japan by greater cooperation with

each other. Some bankers interviewed in the present study indicated their belief that the Canadian banks in Japan sometimes undermine each other's positions by cutthroat competition among each other, in contrast to the implicit cooperative arrangements among some of their competitors, especially the Japanese banks. Once again, the Canadian regulatory environment – in this case, anti-combines restrictions against collusion among firms within the industry at home – may deny Canadian banks in Japan the same degree of freedom available to the Japanese banks themselves.

There is also more that the Canadian banks could do at home to enhance their positions in Japan. This seems evident in the relatively low level of participation by the Canadian banks as intermediaries in placing Japanese-sourced funds via loan activities to Canadian corporate and government borrowers, in relation both to the Canadian securities companies and to Japanese and other foreign banks. There seems to be a danger of the Canadian banks viewing their activities in Japan in isolation from their activities at home. The need for coordinating the treasury function in Japan with the lending function in Canada assumes increasing importance as Japanese investors and Japanese financial institutions become more aggressive in marketing their funds directly to potential Canadian borrowers. Canadian banks might enhance their ability to serve as intermediaries for lending Japanese funds in Canada by establishing a "Japan desk" in each of the major banks at home, to provide coordination, liaison, and domestic marketing effort focussed specifically at Japan-Canada financial flows.

Implications for Canadian Securities Companies

Canadian securities companies have been doing extremely well in Japan, particularly in their role as the main intermediaries in the massive flow of funds from Japanese institutional investors into Canadian government bonds. A major potential problem, however, is their vulnerability from such heavy reliance on a single type of activity. The flow of Japanese funds into Canadian bonds could end abruptly with interest rate changes or other developments, and competition from non-Canadian institutions will certainly become more active, particularly as domestic deregulation in Canada proceeds. Some of the Canadian securities companies in Japan are seeking to reduce their reliance on the Canadian bond market by diversifying into newer business activities such as swaps, private placements, mergers and acquisitions, etc. Much more can probably be done in this direction.

One significant way in which Canadian dealers could help to achieve their diversification objectives would be through a greater emphasis on investor relations in Japan, particularly in helping private Canadian companies to raise their profile among potential institutional and private investors. Japanese investors repeatedly stress the lack of adequate information in Japan about possible equity investment opportunities in Canada. Japanese houses, such as Nomura Securities, place major emphasis on investor relations. While Canadian houses are limited by their relatively small size in Japan, successful efforts to inform Japanese investors of Canadian investment opportunities would not only generate additional volume for the Canadian houses, it would be an important step in diversifying beyond the sale of government bonds. As an example of moves in this direction, McLeod Young Weir plans to begin publishing a Japanese-language edition of its Bond and Money Market Letter and to expand its equity sales force in Japan.

In addition to expanding their sales of Canadian securities to Japanese investors, the Canadian securities companies could do more to take advantage of the very high savings rate of Canadians by promoting the sale of Japanese equities in Canada. Although returns on Japanese equities have been extremely high in recent years, Canadian investment money has only just begun to flow to Japan in appreciable quantities. The Canadian securities companies are in a unique position to promote and market Japanese investment opportunities to Canadians, thus developing a distinctive business niche and achieving further diversification. The time to develop this niche is now, because as financial deregulation proceeds in Canada, Japanese and other foreign securities companies entering Canada will surely become more aggressive in pursuing that market.

Executives of Canadian securities companies seem divided in their perceptions of the degree to which the relatively small size of the Canadian houses handicaps their ability to compete effectively in markets such as Japan. However, competitive pressure will increasingly demand that world-class financial institutions have a highly sophisticated global information and communications network, the ability to hold large inventories of securities, and the capability of offering a wide range of sophisticated financial services. The need for Canadian firms to increase the size of their capital base seems evident in the spate of recent public issue offerings and merger attempts. Additional steps toward merger and consolidation of the Canadian securities industry is probably necessary to achieve the size of capital base and breadth of expertise required to compete effectively with the

global giants in markets such as Tokyo. Current steps to allow foreign securities companies direct access to the Canadian market will provide additional competitive pressure at home, but they will, at the same time, also offer new opportunities for Canadian dealers to acquire more capital and to link up with foreign companies which have already developed expertise in areas where Canadians may be lacking.

For both the banks and the securities companies, two critical prerequisites for successful operation in Tokyo will be minimizing overhead costs and attracting competent staff. Executives of Canadian financial institutions report that even a reasonably healthy level of earnings from financial operations can quickly be swallowed up by space and other overhead costs in Tokyo, to a degree unrivalled in any other major world financial center. Staffing in Tokyo requires an exceedingly difficult balance between the need for technical expertise in the array of emerging financial instruments, on the one hand, and the need for expertise in Japanese language and business protocol on the other. The shortage of competent staff will continue to be the most severe constraint to the expansion of Canadian financial service firms in Tokyo. More competent Japanese will have to be hired, but the cost of attracting and holding them will be extraordinarily high. Greater use of profit-sharing and bonus schemes may be needed as long-term employment incentives.

Implications for Canadian Public Policy

One of the most striking features surrounding Canada-Japan financial flows is the dearth of meaningful statistical information. The massive flow of Japanese capital into Canadian securities has far-reaching policy implications for Canada, yet pathetically little reliable information is available on the source and magnitude of the flows. Several major steps are needed to alleviate this weakness. First, there is a need for Statistics Canada to revise its reporting methods. Most of the data currently published breaks down foreign portfolio financial flows to Canada simply as "U.S." and "Other." Much more refinement is needed. Beyond refining the categories, more attention should be focussed on determining the *original* source of the funds, as opposed to the intermediate locations through which it may have been booked. A significant portion of the Japanese investment flowing into Canada is booked through New York or London, and thus shows up statistically as American or British investment in Canada. Reporting techniques need revision to reflect more accurately the source or origin of the financial flows, in order that

Canadians may assess more realistically the concentration of Canadian financial holdings by country of origin.

A second and related need is for the presence of a full-time financial expert on the staff of the Canadian embassy in Tokyo, as there is already in many other foreign embassies there. Almost exclusive attention is focused at present on trade development and direct investment promotion, even though the financial flows are assuming an increasingly important position in the countries' bilateral relations. An expert is needed to monitor and meaningfully identify for Canadian governments and businesses the ongoing changes in the financial and regulatory environments of Japan, to survey Japanese investors as to the nature and magnitude of their financial dealings with Canadians, and to prepare appropriate policy recommendations for the Canadian Government.

Still another need is for the Government of Canada to exert greater influence upon the Japanese to redirect a larger portion of the Japanese financial flows to Canada toward less liquid forms of investment. Although Japanese portfolio investment in Canadian securities helps to provide needed liquidity to the Canadian economy, the short-term, liquid nature of the holdings exposes Canada to an extremely high risk of major economic disruption if those holdings should be shifted abruptly. Japanese institutional investors are already displaying a greater tendency to invest in longer-term real estate holdings. But the proportion of Japanese financial flows going into *direct* investment in productive activities in Canada remains extremely small, except for a few resource sectors and, more recently, automobiles. Canada's bargaining strength in pressuring Japan toward more direct investment is limited. Nevertheless, the Japanese should be reminded continuously and forcefully of Canada's position as a major destination for Japanese investment flows. Evolution toward a more stable, long-term relationship based on a healthier balance between portfolio and direct investment may ultimately serve the best interests of both sides.

It was repeatedly suggested in the course of the present research that Canadian users of Japanese investment funds – be they federal government, provincial governments, or private Canadian companies – could help enhance the position of Canadian financial institutions by showing more loyalty to Canadian banks and securities houses in their financial dealings with Japan. Concern was expressed particularly at the tendency of provincial governments in Canada to bypass Canadian financial institutions in their loan financing activities. While Canadians may justifiably envy the very strong loyalties which

Japanese companies have with their Japanese financial institutions, there seems little that Canadian governments can or should do, other than to provide a supportive climate in which Canadian banks and securities companies can compete for business freely and effectively as world-class institutions. Legislation, or even strong administrative pressure on the part of Canadian governments, to force more Canadian transactions through Canadian financial institutions would almost certainly be counterproductive in the long term by shielding the Canadian institutions from the full force of competive pressure. There is, however, certainly more that the Government of Canada could do to assist Canadian firms indirectly by helping to inform Japanese investors of Canadian economic and political conditions and of potential Canadian investment opportunities, through "road shows" and other forms of investor communication.

The most important area in which Canadian public policy will impact upon the position of Canadian financial institutions in Japan is in the nature and pace of deregulation of the Canadian financial environment. It is clear that Canadian governments must continue moving to break down the remaining regulator barriers separating the various types of financial institutions in Canada, if Canada's institutions are to achieve the breadth and integration of financial services imperative to today's global competitive environment. It is clear also that Canada must be prepared to continue opening its own domestic economy to the direct competitive presence of foreign financial institutions, both to expose Canadian institutions to the full winds of competitive pressure, and to facilitate their move toward linkages and collaborative arrangements with others. Excessively rapid deregulation will impose significant hardship and even collapse for some Canadian institutions. But foot-dragging and hesitiation at home will place a significant handicap on Canada's financial service firms as they move to position themselves for the opportunities and the challenges of the Tokyo financial market.

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Table 1
Summary of Japan's Balance of Payments, 1981-1985
(US$ billions)

	1981	1982	1983	1984	1985
Exports	149.5	137.7	145.5	168.3	173.9
Imports	129.5	119.6	114.0	124.0	117.9
Balance	20.0	18.1	31.5	44.3	56.0
Invisible & Transfer	(15.2)	(11.2)	(10.7)	(9.3)	(6.7)
Current Balance	4.8	6.9	20.8	35.0	49.3
Net Capital Outflow					
Long-Term	9.7	15.0	17.7	49.7	64.8
Short-Term	(2.3)	1.6	-	4.3	0.7

Source: Bank of Japan

Table 2
Japanese Long-Term Capital Outflows, 1982-1985
(US$ billions)

	1982	1983	1984	1985
Direct Investment	4.5	3.6	6.0	6.5
Loans	7.9	8.4	11.9	10.6
Securities:				
Bonds	6.1	12.5	26.8	53.5
Samurai's etc.	3.5	2.9	4.0	5.3
Stocks	0.2	0.7	0.1	1.0
Trade Credit	3.2	2.6	4.9	3.0
Other	2.0	1.8	3.2	2.3
	27.4	32.5	56.8	82.1

Source: Bank of Japan

Note: Figures may not sum to column totals, due to rounding.

Table 3
Japanese Investment in Foreign Securities, 1982-1986

Year	Stocks			Bonds		
	Purchase	Sale	Net	Purchase	Sale	Net
	(US$ Millions)					
1982	1,126	975	151	16,981	10,905	6,076
1983	2,106	1,447	659	22,907	10,400	12,507
1984	1,570	1,518	51	56,347	29,575	26,772
1985	5,483	4,490	993	291,339	237,860	53,479
1986 (7 months)	7,617	4,759	2,858	662,836	618,120	44,716

Note: The above represents figures through licensed securities companies in Japan only.

Source: Wood Gundy

Table 4
Yen Borrowings by Canadian Entities, 1977-1986
(billion yen)

Year	Samurai	Euro-yen	Syndicated Loans
1977	24	-	20
1978	45	-	-
1979	30	-	70
1980	20	-	-
1981	20	-	11
1982	45	-	5
1983	15	-	10
1984	15	-	213
1985	65	50	170
1986 (to 3/31)	20	135	17
	299[1]	185[3]	516[2]

1. of which 30 billion yen is to Government of Canada
2. of which 200 billion yen is to Government of Canada
3. of which 80 billion yen is to Government of Canada

Source: Bank of Tokyo
Industrial Bank of Japan
Long-Term Credit Bank

Table 5
Japanese Holdings of Foreign Securities Relative to Total Assets – November 30, 1985[a]

Financial Institution	Total Assets		Foreign Securities		
	Amount	Yr.-Yr. Pct. Change	Amount	Yr.-Yr. Pct. Change	As Pct.of Total Assets
Life Insurance Companies	$ 244.4	40%	$ 22.6	51%	9.2%
Casualty Companies	56.9	34	5.0	61	8.8
Trust Accounts (All Banks)	408.4	42	16.5	208	4.0
Pension and Money Trust Accounts[b]	116.6	42	NA	NA	NA
Securities Investment Trust	78.1	32	7.8	180	10.0
Trust Banks (Banking Accounts)	144.9	52	6.1	180	4.2
City Banks	937.8	37	13.2	76	1.4
Regional Banks	513.3	32	8.1	138	1.6
Long-Term Credit Banks	221.4	40	6.6	91	3.0
Postal Life Insurance	137.4	36	4.5	100	3.3
Other Financial Institutions[c]	873.7	22	14.0	75	1.6
Total	**$3,732.9**	–	**$104.4**	–	**2.8%**

a. All figures converted into billions of U.S. dollars at Y202/US$ exchange rate (30 Nov. 85)
b. No data are provided on foreign securities held by pension and money trusts.
c. Financial institutions for which holding of foreign securities are reported.
NA Not available.
Source: Bank of Japan

Table 6
Published Financial Statements of Canadian Bank Branches in Japan as of March 31, 1986
(milions of yen)

Assets	Bank of Montreal	Bank of Nova Scotia	Canadian Imperial Bank of of Commerce	Royal Bank of Canada	Toronto-Dominion Bank
Cash on hand and due from banks	51,742	16,393	17,132	20,183	12,283
Call loans	22,668	10,395	1,438	2,260	9,896
Bills purchased	15,000	16,000	2,500	101,000	-
Purchased monetary claims	898	-	-	-	-
Trading account securities	-	-	-	-	-
Investment securities	-	1,510	3,011	0	570
Loans and discounts	49,690	57,622	26,367	53,750	45,580
Foreign exchange accounts	403	6,083	1,986	4,912	602
Sundry accounts	2,395	2,382	1,876	1,372	28,835
Premises and equipment	947	347	166	369	245
Customers' liability under guarantees and acceptances	520	1,709	661	408	709
Head office and branches	22,498	17,217	21,401	13,420	158,956
Total assets	166,765	129,658	76,541	106,679	257,681
Total loans and discounts as of March 31, 1985	55,731	76,036	22,384	67,715	44,953

Table 8
(continued)

Liabilities	Bank of Montreal	Bank of Nova Scotia	Canadian Imperial Bank of of Commerce	Royal Bank of Canada	Toronto-Dominion Bank
Deposits	11,044	11,023	15,663	10,229	32,615
Negotiable certificates of deposit sold	-	3,000	-	700	-
Call money	26,881	60,361	13,600	25,027	16,367
Bills sold	12,800	-	-	-	-
Borrowed money	13,520	14,707	15,233	16,160	90,120
Foreign exchange accounts	4	364	14	123	0
Sundry accounts	1,256	2,184	1,325	3,668	35,162
Reserve for loan losses	207	223	97	220	193
Reserve for employee severance & retirement	43	38	19	28	19
Other reserves	-	-	-	-	-
Reserves under special law:					
National bond price fluctuation reserve	-	-	-	-	-
Reserve for losses on trading account securities	-	-	-	-	-
Bank's liability under guarantees and acceptances	520	1,709	661	408	709
Head office and branches	100,477	35,911	29,704	50,316	82,143
Sub-total	166,756	129,520	76,318	106,881	257,331
Legal earned reserve and unremitted earnings carried forward (operating losses carried forward)	9	138	223	(202)	349
Total liabilities	166,765	129,658	76,541	106,679	257,681

Table 6
(continued)

Income Statement	Bank of Montreal	Bank of Nova Scotia	Canadian Imperial Bank of of Commerce	Royal Bank of Canada	Toronto-Dominion Bank
Ordinary income:					
Interest on loans	4,327	4,615	2,284	3,452	2,490
Interest and dividends on securities	1	91	244	69	55
Other interest income	6,649	3,449	5,277	2,294	15,904
Other ordinary income	141	766	113	470	352
Total ordinary income	11,119	8,921	7,920	6,285	18,803
Ordinary expenses:					
Interest on deposits	1,096	884	2,332	274	3,486
Other interest expenses	9,483	7,239	4,926	5,338	12,041
Operating expenses	1,210	712	395	645	923
Other ordinary expenses	66	47	154	50	272
Total ordinary expenses	11,856	8,882	7,808	6,308	16,722
Ordinary earnings (loss)	(737)	39	112	(22)	2,080
Extraordinary profits	97	91	-	125	124
Extraordinary losses	11	-	2	0	-
Earnings (loss) before income taxes	(650)	130	109	101	2,205
Refunds of income taxes	-	-	-	-	-
Income taxes	-	-	0	0	1,280
Net earnings (loss)	(650)	130	109	101	924
Net interest income (expense)	398	32	547	203	2,922

Source: Peat, Marwick, Mitchell & Co.
Note: Figures may not sum to column totals, due to rounding.

Table 7
Funding Sources of Canadian Banks in Japan

Canadian banks in Japan can fund themselves in many ways. Some options are listed below.

Access to *local* money markets and yen may be accomplished by:

(1) The issuance of negotiable yen certificates of deposit, and money market certificates.

(2) Reliance on "due to" correspondent bank lines of credit with Japanese banks.

(3) Accessing the inter-bank short-term money markets such as the yen call money market, the yen bill discount market and the gensaki (sell/buy under repurchase agreement) bond market.

(4) Obtaining term borrowings from large Japanese financial institutions such as life insurance companies and trust banks.

(5) Procuring time deposits from Japanese customers. (These are regulated by the Bank of Japan and Ministry of Finance).

(6) Interbank deposits from Japanese banks.

(7) Going to the Bank of Japan discount window.

In addition, *international* transactions provide alternative funding sources. These include:

(1) Dollar/yen swap funding

(2) Non-resident yen deposits or Euroyen deposits. (Subject to reserve requirement and scrutiny of the Bank of Japan.)

(3) Currency/interest rate swaps and Euromarket transactions.

(4) Yen BA market.

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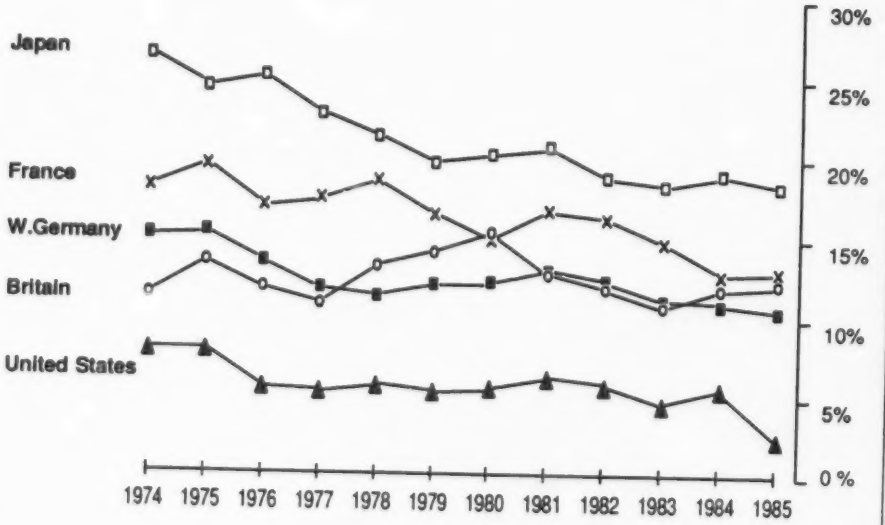
Figure 1 Personal Savings as Percent of Disposable Income

Figure 2 Japanese Balance of Payments: Current Balances and Net Capital Outflows

Figure 1

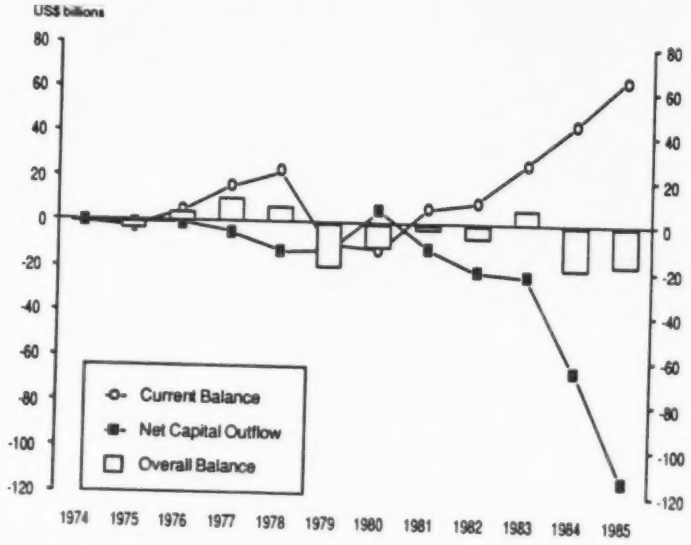
Personal Savings as Percent of Disposable Income



Source: The Economist, March 1986

Figure 2

Japan's Balance of Payments:
Current Balances and Net Capital Outflows



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Appendix

Developments in Financial and Capital Markets in Japan, as of August 6, 1986

Source: Canadian Embassy, Tokyo

DEVELOPMENTS IN FINANCIAL AND CAPITAL MARKETS IN JAPAN (AS OF AUGUST 6, 1986)

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
(1) EUROYEN BONDS & EUROYEN LOANS *(Euroyen Bonds)* – In addition to international organizations and foreign governments, A- or higher-rated foreign enterprises have been authorized to issue Euroyen bonds since April 1, 1986; foreign banks, if A- or higher-rated, have also been authorized to do so since June 1, 1986.		About 60 foreign manufacturers are newly eligible for issuing Euroyen bonds, with total number of such firms increasing to 220 or so. For foreign banks, especially those operating in Japan, this should lead to a broader base for fund-raising sources.	
– Since April 1, 1986, Japanese businesses have been authorized to issue currency-conversion Euroyen bonds and floating rate Euroyen bonds in addition to fixed rate Euroyen bonds; foreign issuers were permitted to do so in June, 1985.		Japanese corporations could take advantage of foreign exchange and money market conditions, thus promoting their issue of Euroyen bonds.	
– Three Japanese organizations have been recognized as official rating agencies since April 1, 1986 in addition to Standard & Poors and Moodies, U.S.A.		Rating of Japanese corporations should be made easier, thus promoting their issue of Euroyen bonds.	
– The seasoning period of Euroyen bonds has been shortened from 180 days to 90 days since April 1, 1986 except for dual currency bonds.		This is expected to promote trading of Euroyen bonds among Japanese investors thus making it easier for them to purchase such bonds.	

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
– Withholding tax of 20% imposed on Euroyen bonds issued by Japanese corporations was abolished on April 1, 1985; No withholding tax was imposed on such bonds issued by international organizations and foreign governments and enterprises.		Removal of the tax should lead many of the Japanese companies now eligible to float Euroyen loans to take advantage of that market.	
– Foreign securities companies were authorized to become co-managing underwriters of Euroyen bonds from December 1, 1984; only Japanese securities companies had been authorized to do so until then.		This will help liberalize the underwriting fee for industrial bonds issued in the Japanese market.	
(Euroyen Syndicate Loans) – Euroyen loans extended to non-residents have been completely liberalized since April 1, 1985; Euroyen loans of less than 1 year were liberalized in June, 1984		This will promote greater offshore trade in yen with less MoF guidance.	Abolition of the ban on mid- and long-term Euroyen Loans to residents.

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
(2) MONEY MARKET *(Call Market)* – The Bank of Japan has authorized unsecured transacitns of two and three weeks' call loans since September 1985; for unconditional and one week call loans, since July 1985.	Unsecured transactions of call loans with longer terms are expected to be authorized in the not-far-distant future.	This should promote arbitration transactions with other markets, say, the Euroyen market.	
(Certificates of Deposits and Money Market Certificates) – The minimum issue amount of CDs by Japanese banks and foreign banks operating in Japan was reduced to 100 million yen in April 1985.	The minimum issue amount is expected to be reduced to 50 million yen in the fall of 1986.	Along with other market opening measures, this should contribute to deregulation of interest rates on large deposits.	Further reduction of the minimum issue amount of CDs.
– Maximum amount of CD and MMC issues, in the case of Japanese banks, has been increased to 200% of each bank's equity capital since April 1986, respectively.	The ceiling on those issues is to be increased to 250% from September 1, 1986.	"	
– Foreign banks have been able to issue CDs (in Japan) equivalent to 40% of the combined total of yen-based securities holdings or equivalent to 8 billion yen, whichever is greater, from April 1, 1984.	There is expected to be an increase in the ceiling on CD issues by foreign banks.	"	
– The maximum maturity of CDs and MMCs has been extended from 6 months to 1 year since April 1, 1986, respectively. (The minimum maturity remains one month)	The maximum maturity is to be extended to 2 years by the spring of 1987.	This could lead to the issue of debentures by city banks and the like in the future, who are not permitted to do so.	Issues of CDs and MMCs of less than 1 month.
– Securities companies have been authorized to deal in CDs since June 1985		"	

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
– Minimum denomination of MMCs stands at 50 million yen now.	Minimum denomination of MMCs is to be reduced to 30 million yen from September 1, 1986.	This step is likely to lead to gradual deregulation of interest rates, including short-term ones.	Further reduction of the denomination of MMCs; removal of or raise the interest rate ceiling on MMCs.
(Treasury Bills) – Treasury bills are at present issued at artifically lower rates than the official discount rate (i.e. Bank of Japan rate).	Establishment of a treasury bill market is under study.	BOJ could manage monetary policy in a more flexible manner and this will have some effect on interest rates over the long term.	Treasury bill issuance through public auction.
(Bankers Acceptance Market) – A yen-based BA market was created on June 1, 1985; securities companies have been permitted to deal since April 1, 1986.		It is hoped that a yen BA market will encourage yen-based exports and imports; the market should be used as a place for short-term fund adjustments. (Use of this market has been very limited so far.)	Trading of dollar- (and other currencies-) based bills in the market; progressive tax rates on yen-based bills drawn by Japanese importers.
(Bond Future Market) – A bond future market was created on October 1, 1985.		It should broaden the scope of transactions on the short-term money market and help improve it.	

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
(3) CAPITAL MARKET *(Samurai Bonds)* – Since April 1, 1986, A-rated foreign issuers (including international organizations and foreign governments) have been authorized to issue Samurai bonds without limits on amount. (As in the case of Euroyen bonds, there are now 5 rating organizations available for such issuers.)		This gives access to the market for more foreign corporations.	
(Sales and Dealing of Government Bonds) – An additional 46 financial organizations (10 regional banks, 29 mutual banks, 5 credit associations, National Federation of Credit Associations and the Central Bank of Commercial and Industrial Cooperatives) have been authorized to deal in floating government bonds in June 1986, with the result that banks and other financial organizations so recognized total 134 including 9 foreign banks.		Over the longer term opening the dealing and trading in government bonds should result in these bonds being issued at rates similar to those of private sector and foreign issues.	Underwriting business by foreign banks in the Tokyo market; Deregulation of commission fee for buying and selling in bonds.

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
(Short-term Government Bonds) – Government bonds with 6 months to maturity have been issued since February 1986.		This could promote arbitration between long- and short-term interest rate transactions.	
(Membership of the TSE) – 10 additional securities companies including 6 foreign ones were approved as members of the Tokyo Stock Exchange on December 24, 1985 (actual membership was granted on February 1, 1986), with member firms now totalling 93.		This could help the TSE to become more international.	Further opening of membership to foreign and Japanese non-member firms; reduction of cost to obtain membership.
(4) INTEREST RATES *(Interest on Large Deposits)* – Interest rates on time deposits of 500 million yen or more have been deregulated on April 1, 1986; interest rates on other deposits are still regulated, controlling the level of interest rates among financial institutions.	Interest rates on time deposits of 300 million yen or more but less than 500 million yen are to be deregulated from September 1, 1986; of 100 million yen or more but less than 300 million yen, from the spring of 1987.	This is expected to promote deregulation of interest rates on smaller deposits.	Postal Savings system, largest deposit regime in world, is independent of MoF/BoJ financial regulation, and controls its own interest rates.
(Interest on Small Deposits) – Interest rates on small deposits are regulated accoss the board, making no difference among financial institutions.	With the introduction of small MMCs in the next spring, interest rates on small deposits are to be deregulated gradually for the following 3 to 5 years; the deregulation for time deposits will precede that for demand deposits.	Competition for collecting money should be much more severe among financial organizations, including securities companies.	

PRESENT SHARE	PLANNED STEPS	IMPLICATIONS	PROBLEMS UNSOLVED
(5) OTHERS *(Trust Banking)* – 9 foreign trust banks have been licensed to participate in the trust banking business in Japan since the fall of 1985.		This should cause increased competition in the pension funds market.	
(Foreign Currencies) – From June 1, 1984, both Japanese banks and foreign banks operating in Japan have been authorized to bring foreign currencies into Japan without limits.		This will lead to a broader base of banking business for foreign banks; Japanese businesses should be able to gain access to cheaper funds.	
(Future Trade of Foreign Exchange) – Since April 1, 1984, Japanese (non-financial) corporations have been able to do future trading of foreign exchange regardless of whether: 1) they have concluded contracts on external trade (real demand rule); 2) they have foreign currenty-based securities.		This breaks a corporation's dependance on banks for foreign exchange hedging.	
(Tokyo Offshore Market) – there exists no such a market in Japan.	A Tokyo offshore market (international banking facility) is to be created in October 1986.	It should promote the internationalization of the yen.	Elimination of "withholding tax" on interest earned and local taxes, to make the offshore market competitive internationally.

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This book is about the challenge and the opportunity Japan offers to Canadian financial institutions. Canadian banks will have to move beyond their traditional commercial banking activities, where Japanese financial institutions have a well-established edge, into newer, more creative money and capital market activities. And traditional structures between the various banking activities must blur in order for Canada to acquire the same breadth of financial expertise as other global players. Canadian banks also must blur the distinction they tend to make between their activities at home and in Japan.

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The massive flow of Japanese capital into Canadian securities is one of the public policy issues discussed. The most important, in the authors' opinion, is the nature and pace of deregulation. The authors argue that Canada must open itself to foreign financial institutions, not only to expose itself to the reality of competitive pressures, but also to forge the links and collaborative arrangements needed to survive and prosper.

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